ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Cogdill	Analyst:	Marion Mann DeJong	Bill Number:	AB 290
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/16/2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Manufacturers' Investment Credit/Extend to Agricultural & Mineral Extraction Activities

SUMMARY

This bill would extend the Manufacturers' Investment Credit (MIC) to certain agricultural or mineral extraction businesses.

PURPOSE OF THE BILL

The purpose of this bill appears to be to expand the MIC to encourage investment in certain agricultural property and mineral extraction property.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve the constitutional issue. See "Legal Considerations" below. In addition, amendments are needed to clarify how extractive activities fit into the activities contained in the definition of qualified property. See "Implementation Considerations" below. Department staff is available to assist the author with amendments.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business. These laws also allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade or business or held for the production of income.

Existing federal law does not have a credit comparable to the MIC. However, federal law does provide an investment property credit for certain depreciable or amortizable property that qualifies for the rehabilitation, energy, or reforestation credit.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Alan Hunter for GHG	03/22/01
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____ N	____ OUA	__X__ PENDING		

Existing state law allows qualified taxpayers a credit, known as the MIC, equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily:

- for manufacturing, processing, refining, fabricating, or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) For certain taxpayers engaged in specified SIC Code activities, special purpose buildings and foundations.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

<u>THIS BILL</u>

This bill would add taxpayers engaged in agricultural activities and extracting nonmetallic minerals to the definition of "qualified taxpayer." The agricultural activities are described in Standard Industrial Classification (SIC) Codes 0111 to 0291, inclusive, and in Code 0724. The extracting nonmetallic minerals are described in SIC Codes 1411 to 1499, inclusive. See "Attachment A" for a brief description of the activities in these codes.

This bill would modify the definition of "qualified property" to include tangible personal property (IRC Section 1245(a) property) used by a qualified taxpayer in extracting nonmetallic minerals primarily for "extracting property." Costs would include capitalized labor costs for the construction or modification of this property. This bill would modify the list that currently excludes all extraction property from the definition of qualified property to include certain extraction property in the definition. Specifically, equipment used for extraction processes described in SIC Codes 1411 to 1499, inclusive, would be considered qualified property.

For qualified taxpayers that are engaged in agricultural businesses, qualified property would include tangible personal property primarily used by that taxpayer in connection with the packaging, cold storage, or preparing of agricultural commodities. Capitalized labor costs for the construction or modification of this property would not qualify for the credit. “Qualified property” would not include facilities used for warehousing purposes after completion of the preparing process.

“Agricultural commodities” would be defined as the products of California farms and ranches and items processed from these products, such as forest products, aquacultural products, fish and fish products produced in California, and livestock fed in feedlots located in California.

“Preparing” would be defined as those activities that, after an agricultural commodity has been grown and harvested, are required to make the agricultural commodity ready for manufacturing, processing, or wholesale or retail sale.

“Tangible personal property that is primarily used in connection with the cold storage of agricultural commodities” would be defined as the specific capital equipment used for refrigeration. This would include, but not be limited to, compressors, pumps, fans, heat exchangers, and related machinery specifically related to the refrigeration process. The term would include the refrigeration equipment in or outside the cold storage building that is purchased as a functioning unit to cool the building. However, it would not include the cold storage building itself or any modification, such as insulation, wall coverings, or plumbing, made to the cold storage building.

This bill would further modify the existing definition of qualified activity in the qualified property rules by expanding the commencement point of the manufacturing or other process to include when raw materials are “obtained or received” within this process instead of just when “received.”

The binding contract rules in the MIC would be modified so that purchases of equipment pursuant to a binding contract entered into before January 1, 2001, by taxpayers engaged in agricultural or mineral extraction activities would not qualify for the credit.

This bill also would make minor technical changes to delete obsolete language referencing the low-emission vehicle credit and change “which” to “that” in various places.

IMPLEMENTATION CONSIDERATIONS

Under current law, the definition of qualified property includes tangible personal property used for specified activities, beginning at the point where raw materials are introduced into the process and *ending at the point where the activity has altered tangible personal property to its completed form, including packaging, if required*. This bill would add “extracting” to the list of activities that define the end of the process. However, it is unlikely that extractive activities could ever result in the altering of tangible personal property to its completed form. Thus, the definition of qualified property may not properly address extractive activities. This could result in some extractive industry taxpayers not being entitled to the MIC as intended by this bill. This could result in disputes between taxpayers and the department.

LEGISLATIVE HISTORY

AB 2461, Runner (1999/2000) would have (1) increased the MIC from 6% to 7% of the cost of certain property used in manufacturing, (2) extend the credit to certain electric power generation or mineral extraction businesses, and (3) extend the credit indefinitely. The mineral extraction provision of AB 2461 was identical to the mineral extraction provision of this bill. AB 2461 was held in the Assembly Revenue and Taxation Committee.

SB 818, Poochigian (1999/2000) would have extended the MIC to certain agricultural businesses. SB 818 was similar to the agricultural provision of this bill. SB 818 was held in the Senate Rules Committee.

SB 875, Poochigian and Johannessen (2001/2002) is identical to this bill. *AB 240, Runner (2001/2002)* is identical to AB 2461 (1999/2000). Thus, the mineral extraction provision of AB 240 is identical to the mineral extraction provision of this bill.

OTHER STATES' INFORMATION

New York provides an investment tax credit (ITC) to manufacturers for depreciable equipment or buildings. The credit is 5% of up to $350 million of qualified expenditures and 4% for qualified expenditures in excess of $350 million.

Illinois provides a replacement tax investment credit equal to 0.5% of the basis of qualified property used in Illinois by a taxpayer primarily engaged in manufacturing, retailing, coal mining, or fluorite mining.

Massachusetts provides a 3% credit based on the cost of qualified property used for manufacturing, farming, fishing, or research and development.

Michigan provides a graduated investment tax credit based on adjusted gross receipts of a firm. The credit is a percentage (0.85% to 2.3%) of the net costs of qualifying tangible, depreciable assets located in Michigan.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate:

Extending the MIC to the extraction of nonmetallic minerals and certain agricultural activities would result in the following revenue losses:

Revenue Impact of AB290 For Taxable Years Beginning On Or After January 1, 2001 Assumed Enactment After June 30, 2001 (In Millions)		
2001-02	2002-03	2003-04
-$9	-$11	-$11

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion:

This estimate is based on data from an U.S. Census Bureau survey of capital expenditures by relevant industries for 1998, value of machinery and equipment in place for 1992 and 1987, and microsimulation models of California tax returns for tax years 1997 and 1998. These numbers were grown to approximate 2001 and beyond. The credit use rates taken from the models were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on the department's analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

This estimate does not include losses resulting from qualified taxpayers as defined under current law that might receive additional credits for activities that would qualify under the changes made by this bill. Such losses cannot be quantified since the data and information needed are not available.

LEGAL IMPACT

This bill would allow a credit for equipment used in connection with agricultural commodities, which are limited to the products of farms and ranches in California or items processed from those products. However, it would not provide a credit if the same activity occurs with regard to agricultural commodities from farms and ranches outside of California. The effect of that distinction is to discriminate in favor of a local economy, which is likely unconstitutional under the Commerce Clause of the United States Constitution. If the author intends to limit the credit to processing activities that occur in California, this issue could be resolved by limiting the credit to property used in California. Department staff is available to assist the author with any amendments.

ARGUMENTS/POLICY CONCERNS

- This bill would allow the qualified taxpayers involved in agricultural activities to claim the credit based on costs incurred in storing the commodities. This would establish a precedent for the MIC since no other taxpayers are allowed the MIC with respect to storage costs.

- The bill would amend the qualified activity definition within the qualified property definition by expanding the "process" (manufacturing, processing, refining, etc.) to include "the point at which any raw materials are obtained." Because this change is not limited to the extractive activities added by this bill, it would allow existing qualified taxpayers to claim the MIC for equipment used to transport raw materials from the point that they are obtained (for example, a warehouse owned by the taxpayer) to the actual manufacturing, fabricating, etc., site. Under current law, such equipment would not qualify for the MIC because the MIC is limited to equipment use beginning at the point where raw materials are "received."

  Further, if the term "obtained" were construed to mean the point at which title transfers, then a taxpayer that transported raw materials by trucks that it owned or leased, regardless of distance, would be entitled to claim the MIC for the costs of the trucks. Under current law the trucks would not qualify since they would not be treated as equipment used in the "process" qualifying the taxpayer for the MIC.

- The bill amended the binding contract rules so that purchases of equipment pursuant to a binding contract entered into before January 1, 2001, by taxpayers engaged in agricultural or mineral extraction activities would not qualify for the credit.

However, it did not change the dates in the binding contract rules for certain leases of qualified property. Thus, equipment leases entered into prior to January 1, 2001, would qualify for the credit without being subject to the cash flow allocation rules contained in the binding contract rules. This would treat taxpayers differently depending on whether they purchased or leased their equipment.

LEGISLATIVE STAFF CONTACT

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Attachment A
Standard Industrial Classification (SIC) Codes

SIC Codes 0111 to 0291 and 0724

MAJOR GROUP 01. AGRICULTURAL PRODUCTION--CROPS

011	CASH GRAINS
0111	Wheat
0112	Rice
0115	Corn
0116	Soybean
0119	Cash Grains, Not Elsewhere Classified
013	FIELD GRAINS, EXCEPT CASH GRAINS
0131	Cotton
0132	Tobacco
0133	Sugarcane and Sugar Beets
0134	Irish Potatoes
0139	Field Crops, Except Cash Grains, Not Elsewhere Classified
016	VEGETABLES AND MELONS
0161	Vegetables and Melons
017	FRUITS AND TREE NUTS
0171	Berry Crops
0171	Grapes
0173	Tree Nuts
0174	Citrus Fruits
0175	Deciduous Tree Fruits
0179	Fruits and Tree Nuts, Not Elsewhere Classified
018	HORTICULTURAL SERVICES
0181	Ornamental Floriculture and Nursery Products
0182	Food Crops Grown Under Cover
019	GENERAL FARMS, PRIMARILY CROP
0191	General Farms, Primarily Crop

MAJOR GROUP 02. AGRICULTURAL PRODUCTIONS--LIVESTOCK AND ANIMAL SPECIALTIES

021	LIVESTOCK, EXCEPT DAIRY AND POULTRY
0211	Beef Cattle Feedlots
0212	Beef Cattle, Except Feedlots
0213	Hogs
0214	Sheep and Goats
0219	General Livestock, Except Dairy and Poultry
024	DAIRY FARMS
0241	Dairy Farms
025	POULTRY AND EGGS
0251	Broiler, Fryer, and Roaster Chickens
0252	Chicken Eggs
0253	Turkey and Turkey Eggs
0254	Poultry Hatcheries
0259	Poultry and Eggs, Not Elsewhere Classified
027	ANIMAL SPECIALTIES
0271	Fur-Bearing Animals and Rabbits
0272	Horses and Other Equines
0273	Animal Aquaculture
0279	Animal Specialties, Not Elsewhere Classified
029	GENERAL FARMS, PRIMARILY LIVESTOCK AND ANIMAL SPECIALTIES
0291	General Farms, Primarily Livestock and Animal Specialties

Attachment A

MAJOR GROUP 07. AGRICULTURAL SERVICES
072 CROP SERVICES
724 Cotton Ginning

SIC Codes 1411 to 1499:

MAJOR GROUP 14. MINING AND QUARRING OF NONMETALLIC MINERALS, EXCEPT FUELS
141 DIMENSION STONE
1411 Dimension Stone
142 CRUSHED AND BROKEN STONE, INCLUDING RIPRAP
1422 Crushed and Broken Limestone
1423 Crushed and Broken Granite
1429 Crushed and Broken Stone, Not Elsewhere Classified
144 SAND AND GRAVEL
1442 Construction Sand and Gravel
1446 Industrial Sand
145 CLAY, CERAMIC AND REFRACTORY MINERALS
1455 Kaolin and Ball Clay
1459 Clay, Ceramic and Refractory Minerals, Not Elsewhere Classified
147 CHEMICAL AND FERTILIZER MINERAL MINING
1474 Potash, Soda, and Borate Minerals
1475 Phosphate Rock
1479 Chemical and Fertilizer Mineral Mining, Not Elsewhere Classified
148 NONMETALLIC MINERALS SERVICES, EXCEPT FUELS
1481 Nonmetallic Minerals Services, Except Fuels
149 MISCELLANEOUS NONMETALLIC MINERALS, EXCEPT FUELS
1499 Miscellaneous Nonmetallic Minerals, Except Fuels